

ORIGINAL

OPEN MEETING AGENDA ITEM



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BEFORE THE ARIZONA CORPORATIC

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Arizona Corporation Commission

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MAY 28 2013

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COMMISSIONERS

BOB STUMP—Chairman
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IN THE MATTER OF THE APPLICATION
OF JOHNSON UTILITIES, L.L.C. DBA
JOHNSON UTILITIES COMPANY, FOR AN
INCREASE IN ITS WATER AND WASTE-
WATER RATES FOR CUSTOMERS WITHIN
PINAL COUNTY, ARIZONA.

DOCKET NO. WS-02987A-08-0180

RESPONSE TO STAFF REPORT

On March 8, 2013, Johnson Utilities, L.L.C. ("Johnson Utilities" or the "Company") filed a Petition to Amend Decision 71854 Pursuant to A.R.S. §40-252 ("Petition") to permit the Company to increase its rates and charges to recover income tax expense in its cost of service. On April 26, 2013, the Utilities Division Staff ("Staff") filed its Staff Report and proposed form of order recommending approval of the rate increase and associated rate design filed by the Company. However, Staff also recommends that the Company file a rate case by June 30, 2015, using a 2014 calendar year test year, and states its belief that income taxes for pass-through entities should be classified as an "allowance." Johnson Utilities opposes Staff's recommendation regarding the filing of a rate case and disagrees that imputed income taxes should be classified as an allowance as opposed to an expense.

1. Johnson Utilities Opposes Staff's Recommendation that the Company File a Full Rate Case Using a 2014 Calendar Test Year.

In its Staff Report, Staff included the following recommendation:

Because of the length of time between rate cases that would occur if the Company did not file a new rate case application for several years, Staff recommends that the Company be ordered to file a full rate case application for its water and wastewater divisions by no later than June 30, 2015, using a 2014 calendar year test year.

Johnson Utilities opposes this Staff recommendation because it is unnecessary and will cause the Company to apply for a rate increase earlier than would otherwise be the case. On August 25, 2010, the Commission issued Decision 71854 which ordered decreases in the Company's rates and charges for both water and wastewater services retroactive to June 1, 2010. Pursuant to Decision 72579 issued September 15, 2011, the sewer rates were subsequently increased for billings after October 1, 2011, to address a correction in the Company's rate base. Because the Company's water division had a negative rate base during the test year, its current water rates are based on a 3% operating margin, which is a very low operating margin. The Company's current sewer rates are based on a rate of return of only 8%, a low rate of return.

Even with the proposed increase in rates to include income tax expense, water customers of Johnson Utilities will still have lower water rates today than the Company's initial rates approved in 1997. This means that water customers have not seen an increase in their water rates since the Company commenced operations sixteen years ago.

Similarly, sewer customers currently pay approximately what they paid for sewer service when the Company's initial sewer rates were approved in 1997. With the proposed new sewer rates to address income tax expense, a customer with a ¾-inch water meter will see an increase in sewer rates of less than \$3 per month.

In Decision 72579, the Commission ordered that Johnson Utilities could not file a rate case with a test year earlier than December 31, 2012, stating as follows:

We further find and conclude that because we make these modifications to Decision No. 71854, the public interest requires a stay out provision that prohibits the Company from filing a future rate increase application that uses a test year ending earlier than December 31, 2012. (emphasis added)

Notwithstanding the Commission's conclusion as recently as September 15, 2011, that "the public interest requires a stay out provision," Staff has recommended that Johnson Utilities file a rate case using a 2014 test year. However, the Company's rates for water and sewer service are fair to customers at current levels. Staff expressly acknowledged this fact in the Staff

1 Report when it stated that “Staff concurs with these amounts because they comply with the
2 Commission’s new policy and will therefore result in just and reasonable rates.”¹

3 In its Petition, Johnson Utilities stated that it “believes it will not need to seek a further
4 increase in its rates and charges that would become effective before the sixth anniversary of the
5 date of a decision on the Petition in this docket, or July 1, 2019, whichever is earlier.” However,
6 if Johnson Utilities is ordered to file a rate application in 2015 with a 2014 calendar year test
7 year, it will certainly seek to increase rates and charges given that the Company has a small 3%
8 operating margin for the water division and a low 8% rate of return for the wastewater division.
9 Thus, there is no good reason for Staff’s recommendation that the Company file another rate
10 case so soon. Johnson Utilities should control the timing of its next rate case. If the
11 Commission or Staff has a concern about the Company’s earnings, it always has the authority to
12 issue an order directing the Company to file for a rate review.

13 For the reasons set forth above, Johnson Utilities requests that the Commission reject
14 Staff’s recommendation requiring the filing of a rate case, and modify the proposed form of
15 order by revising Conclusion of Law 7 on page 5 and the first ordering paragraph at the top of
16 page 6, as follows:

17 7. Staff’s recommendations are reasonable and hereby approved, except that
18 we will not adopt Staff’s recommendation in Finding of Fact 21 requiring the
19 Company to file a full rate case no later than June 30, 2015, using a 2014 calendar
20 year test year.

21 * * *

22 IT IS FURTHER ORDERED that the recommendations of Staff discussed in
23 Findings of Fact 19 ~~through 21~~ and 20 are reasonable and are hereby adopted.²

24 For the Commission’s convenience, Johnson Utilities has attached a form of proposed
25 amendment as Attachment 1.

26
27
28 ¹ Staff Report at p. 1.

² Deleted text is denoted by a strike-through and added text is denoted by underscoring.

2. **Johnson Utilities Disagrees with Staff's Belief that Income Tax Expense for Pass-Through Entities Should be Treated as an Allowance and Not an Imputed Expense.**

In its Staff Report, Staff states that “for purposes of accounting, auditing, bookkeeping, and other associated activities, the Commission was correct on page 3 of its policy statement in classifying the income taxes for pass-through entities as an ‘allowance.’”³ However, Staff also states that “for ratemaking purposes, the Commission could elect to classify this adjustment as an imputed expense, which would also be consistent with the intent of the Commission’s policy.”⁴ Johnson Utilities believes that these statements in the Staff Report may create confusion or ambiguity where none exists. In the Commission’s policy statement adopted in Decision 73739, the Commission is very clear, stating that “we hereby adopt a new policy which allows imputed income tax expense in the cost of service for limited liability companies, Subchapter S corporations and partnerships.”⁵ Income taxes for tax pass-through entities should properly be treated as an imputed expense item—like they are in the case of C corporations—and not an allowance. Treating income tax expense as an allowance which increases the fair value rate of return (“FVROR”) potentially negates the purpose of the policy statement because imputed income tax expense can be removed from the cost of service by simply reducing the FVROR.

In its 2005 Policy Statement on Income Tax Allowance, the Federal Energy Regulatory Commission (“FERC”) specifically acknowledged the impracticality of adjusting the rate of return to “equalize” the pre-tax and after-tax returns of a utility.⁶ Accordingly, FERC recognized income tax expense as a part of the cost of service, whether the utility is a tax pass-through entity or a C corporation.⁷

³ Staff Report at 2.

⁴ *Id.* at pp. 2-3.

⁵ Decision 73739, Attachment 1 (Policy Statement on Income Tax Expense for Tax Pass-Through Entities) at p. 2.

⁶ FERC Policy Statement on Income Tax Allowances, Docket No. PL05-5-000 (May 4, 2005), ¶ 40.

⁷ *Id.* See also Rebuttal Testimony of Marc L. Spitzer at p. 3 in Docket No. W-02199A-11-0329 *et al.*

Staff correctly acknowledges in its Staff Report that the Commission's terminology used in its policy statement is consistent with that used by the FERC.⁸ In the FERC context, the income tax allowance is part of the cost of service and therefore has the same meaning as an imputed expense.⁹ The Commission's policy statement and the procedures for determining the income tax expense allowance set forth therein are entirely consistent with the cost of service treatment of income taxes and do not infer any impact on FVROR. Thus, there is no reason to parse the terminology used in the policy statement or to engage in an analysis of the impact of imputed income tax expense on FVROR.

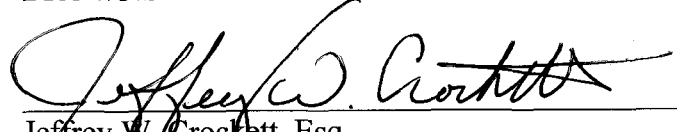
For the reasons discussed above, Johnson Utilities requests that the Commission clarify the proposed form of order by revising the last sentence of Finding of Fact 16 on page 4, as follows:

However, for ratemaking purposes, the Commission ~~could elect to~~ will classify this adjustment as an imputed expense, which ~~would be consistent with~~ is the intent of the Commission's policy.¹⁰

For the Commission's convenience, Johnson Utilities has attached a form of proposed amendment as Attachment 2.

RESPECTFULLY submitted this 28th day of May, 2013.

BROWNSTEIN HYATT FARBER SCHRECK LLP



Jeffrey W. Crockett, Esq.
One East Washington Street, Suite 2400
Phoenix, Arizona 85004
Attorneys for Johnson Utilities, L.L.C.

⁸ Staff Report at p. 2.

⁹ An imputed expense, like an expense allowance, is part of the cost of service.

¹⁰ Deleted text is denoted by a strike-through and added text is denoted by underscoring.

1 ORIGINAL and thirteen (13) copies of the foregoing
2 filed this 28th day of May, 2013, with:

3 Docket Control
4 ARIZONA CORPORATION COMMISSION
5 1200 West Washington Street
6 Phoenix, Arizona 85007

7 COPY of the foregoing hand-delivered
8 this 28th day of May, 2013, to:

9 Lyn Farmer, Chief Administrative Law Judge
10 Hearing Division
11 ARIZONA CORPORATION COMMISSION
12 1200 West Washington Street
13 Phoenix, Arizona 85007

14 Janice Alward, Chief Counsel
15 Legal Division
16 ARIZONA CORPORATION COMMISSION
17 1200 West Washington Street
18 Phoenix, Arizona 85007


19 Steve Olea, Director
20 Utilities Division
21 ARIZONA CORPORATION COMMISSION
22 1200 West Washington Street
23 Phoenix, Arizona 85007

24 Copy of the foregoing sent via e-mail and first
25 class mail this 28th day of May, 2013, to:

26 Daniel Pozefsky, Chief Counsel
27 RESIDENTIAL UTILITY CONSUMER OFFICE
28 1110 West Washington Street
Phoenix, Arizona 85007

James E. Mannato, Town Attorney
TOWN OF FLORENCE
P.O. Box 2670
775 N. Main Street
Florence, Arizona 85232-2670

Craig A. Marks
CRAIG A. MARKS, PLC
10645 N. Tatum Blvd. Suite 200-676
Phoenix, Arizona 85028


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Attachment 1

COMPANY PROPOSED AMENDMENT # 1

DATE PREPARED: May 28, 2013

COMPANY: Johnson Utilities, L.L.C.

DOCKET NO.: WS-02987A-08-0180

OPEN MEETING DATES: June 11-12, 2013 AGENDA ITEM: U-

Page 5, line 24,

AFTER the word "approved" INSERT a comma and ADD "except that we will not adopt Staff's recommendation in Finding of Fact 21 requiring the Company to file a full rate case no later than June 30, 2015, using a 2014 calendar year test year."

Page 6, line 2,

DELETE the words "through 21" and INSERT the words "and 20."

Make all other conforming changes.

Attachment 2

COMPANY PROPOSED AMENDMENT # 2

DATE PREPARED: May 28, 2013

COMPANY: Johnson Utilities, L.L.C.

DOCKET NO.: WS-02987A-08-0180

OPEN MEETING DATES: June 11-12, 2013 AGENDA ITEM: U-_____

Page 4, line 13,

DELETE the words "could elect to" and REPLACE with the word "will."

Page 4, lines 13-14,

DELETE the words "would be consistent with" and REPLACE with the word "is."

Make all other conforming changes.